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Hon. Bill Lockyer
State Treasurer
915 Capitol Mall
Room 110
Sacramento, CA 95814

Re: Bond Ratings and S.E.C. Rule 2a-7 Under the Investment Company Act of 1940

Dear Treasurer Lockyer:

We are writing in response to your initiative concerning the standards being applied by bond rating agencies in rating municipal governments, as set out on your website section "fairbondratings.com" We support your efforts in this initiative.

While we do not have much direct expertise in areas of financial analysis, default risk, etc., we do want to point out one area, dealing with Securities and Exchange Commission (S.E.C.) regulations, where we do have some insight which may bear on these topics. Mutual Funds are regulated under the Investment Company Act of 1940. There are many such funds that invest in municipal bonds. One category of mutual funds are so-called "money market funds" which were created to provide a highly liquid investment for individual or institutional investors, but designed to achieve somewhat higher yields than bank accounts. Since money market funds, unlike bank accounts, are not federally insured, the S.E.C. has developed regulations governing money market funds to try to minimize any risk of loss for investors. The principal regulation in this area is Rule 2a-7 under the Investment Company Act of 1940, or simply "Rule 2a-7."

Rule 2a-7 consists of a number of highly technical provisions, which include limits on the length of maturity and minimum standards for the credit quality of the securities which a money market fund may purchase. In general, to qualify for purchase by a money market fund, a debt security must be rated in one of the two highest rating categories (i.e., "AA" or "AAA" or the equivalent categories for short-term ratings) by two rating agencies (called "nationally recognized statistical rating organizations," of which there are presently five approved by the S.E.C.). As will be described below, the ratings may be based on the underlying credit ratings of the municipal issuer, or on the rating of a financial institution providing credit enhancement for the bonds in question, or on both.

In examining this matter in more detail, it is necessary to understand some of the definitions used in Rule 2a-7, which unfortunately is written in a very convoluted manner. One critical definition is that of a "guarantee," which means an unconditional obligation of any person other than the issuer of the security to pay the principal of and interest on the security when due if there is a default by the issuer. If a guarantee is rated in one of the two highest rating categories, it makes the security which is guaranteed eligible for purchase by a money market fund (assuming compliance with the various other requirements of Rule 2a-7).

While money market funds are required to purchase only securities with a short maturity, municipal issuers have created long-term bonds (called "variable rate demand bonds") which have a "put" or tender feature allowing or requiring the investor to sell the security back with certain notice or at certain specified times. Rule 2a-7 allows the fund to treat this "put" notice period as being the maturity of the bond, and there is a very large market for these instruments. In order for the "put" feature to be viable (since it potentially requires access to large amounts of cash on short notice), most issuers obtain credit enhancement from banks or other large financial institutions to guarantee the repurchase of the bond if it cannot be remarketed to another investor, which is the most common occurrence. These credit enhancements take two forms: letters of credit and liquidity lines (also called standby purchase agreements).

With a letter of credit, the bank makes an irrevocable undertaking to support the payment of principal and interest, and to purchase bonds which have been tendered but not remarketed. This undertaking remains for a set period of time and cannot be cancelled by the bank. Hence, it is viewed as "full credit substitution" in that an investor only needs to look to the bank for payment of the bonds, and the investor is effectively insulated from risk of nonpayment by the issuer. Under Rule 2a-7, such a form of credit enhancement is called an "unconditional demand feature." When a money market fund purchases a bond with an unconditional demand feature, it must verify that the credit enhancer has short-term ratings in one of the two highest categories; the issuer's ratings do not come into play. An unconditional demand feature also fits within the definition of a "guarantee."

With a standby purchase agreement, the credit enhancer only promises to purchase tendered bonds, and regular payments of principal and interest are either enhanced by another institution (typically a bond insurance company) or are unenhanced. Unlike letters of credit, standby purchase agreements typically contain covenants under which, if certain events occur, the credit provider's obligation may terminate immediately. (Since the obligation of a standby bond purchaser is less extensive than that of a letter of credit provider, standby agreements are less expensive to the issuers.) Accordingly, investors in variable rate demand bonds backed only by a standby agreement need to look separately to the credit of the liquidity bank to cover the tender obligations, and to the credit of either a bond insurer or the issuer itself for coverage of default risk on payments of principal and interest while the investor holds the bond.

In the language of Rule 2a-7, a standby purchase agreement is a "conditional demand feature." As with an unconditional demand feature, the provider of the conditional demand feature must have short-term ratings in one of the two highest categories. However, Rule 2a-7 has several *additional* requirements which the money market fund must meet with respect to a conditional demand feature. For purposes of this analysis, the most important additional requirement is that the underlying security must *also* have ratings in one of the two highest categories. This second rating test for the underlying security can be met either by the rating of the issuer itself, or by use of another credit enhancement which is a "guarantee," such as a bond insurance policy.

Therefore, for purposes of Rule 2a-7, with a standby purchase agreement, the money market fund needs to verify that the ratings of both the standby purchaser *and* the underlying security are *each* in one of the two highest rating categories. If the underlying security is itself only a short-term instrument, such as commercial paper, the ratings in question are the short-term ratings of that instrument, but if the underlying security is a long-term bond with "put" features, the rating in question is the long-term rating of that issuer or of a bond insurer.

Many issuers over the past years have used a combination of a standby purchase agreement and a bond insurance policy in order to create a security which is eligible for purchase by money market funds. Although the standby purchase agreement is only a conditional demand feature, the existence of the bond insurance, as a guarantee, makes the bonds eligible. This combination has often been less expensive than purchasing a letter of credit, which is an unconditional demand feature/guarantee. What has happened in the market in the past few months is that several of the bond insurers have lost their top-tier ratings, and no longer qualify to provide a guarantee which meets Rule 2a-7 requirements. This has led to turmoil in the market and to significant increase in demand for letters of credit, thereby increasing the cost of letters of credit. Likewise, the cost of bond insurance from the smaller remaining universe of the most highly rated insurers is going up.

Municipal issuers with ratings on their long-term bonds below the top two categories are at a significant disadvantage compared to higher-rated issuers in developing bond issues eligible for purchase by money market funds. The issuer with ratings in the top two categories can use a standby purchase agreement – a conditional demand feature – without having to purchase bond insurance, because its own issuer rating meets the requirement for having sufficient credit quality on the underlying security. By contrast, an issuer without ratings in the top two categories must pay a higher price to obtain an unconditional demand feature to secure its bonds – either a letter of credit or a standby purchase agreement with bond insurance -- even though there may be very little objective difference in the risk of default by the issuer in either instance.

Your initiative to have rating agencies use a similar standard of analysis, which focuses on risk of default, for both corporate and municipal issuers would result in more municipal issuers falling into the two highest rating categories of the major rating agencies. This would benefit municipal issuers seeking to place bonds with money market funds, by allowing them to forego costly bond insurance

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in many cases while avoiding the greater cost of a letter of credit as compared to a standby purchase agreement. It would also benefit the funds by broadening the universe of bonds which they can purchase and reducing their risk of having to dispose of bonds in case of downgrades of bond insurers. In this regard, we note that Moody's Investors Service will in the near future offer municipal issuers the ability to obtain a "global scale rating" which in most instances is higher than its existing municipal scale. If Moody's continues to provide both ratings, there may still be difficulties under Rule 2a-7, which is not entirely clear as to which rating scale would need to be used by a money market fund to determine the credit quality of a security. Unless and until the S.E.C. clarifies this point, money market funds are likely to take a conservative approach.

Please share or use this letter in any manner which may be useful in your initiative, and do not hesitate to contact any of us if you have any questions or if we may be of further assistance.

Very truly yours,

Robert P. Feyer for

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